Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:[redacted]:TL-N-~~5522-98~~ 862-99
[redacted]

date: SEP 17 1998

to: Chief, Examination Division, [redacted] District
Attn: Revenue Agent [redacted]

from: District Counsel, [redacted]

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subject: **Request for Advice on [redacted]**
E.I. No. [redacted]

This is in response to your memorandum dated August 4, 1988 requesting legal advice on the issue of whether [redacted] should be denied special tax treatment under I.R.C. § 833 because of a material change in its operations. For the reasons set forth below, we recommend that you secure additional information regarding the change in the operations of the entity. After that information is secured, an analysis should be made to determine whether the adjustment, if any, proposed by the Examination Division should be submitted to the National Office under Technical Advice procedures.

FACTS

The relevant facts, as we understand them, are as follows. [redacted] (the taxpayer) is the parent of a related group of corporations. The parent and its [redacted] subsidiaries are members of the [redacted]. The [redacted] subsidiaries are a [redacted] insurance company, a [redacted] insurance company and an [redacted] agency. The group files a consolidated federal income tax return as an organization described in I.R.C. § 833.

Based on statements filed by the taxpayer with the [redacted] in [redacted] and [redacted] the taxpayer underwrote [redacted] insurance on groups of less than [redacted] individuals. For additions to old groups, the applicant was subject to evidence of insurability. Individuals, subscribers and dependents leaving a group could continue membership subject to the provisions in their contract.

Based on the [redacted] Annual Statement filed with the [redacted] the state required the taxpayer to underwrite medical insurance on groups of less than [redacted] individuals. Newly hired employees were required to complete a

length of service eligibility period. Non-group business was medically underwritten, except that conversion policies were issued without evidence of insurability if an application was received within the required time frame.

During [redacted], the taxpayer had the following underwriting policies. Individuals were underwritten for insurance based initially on the applicant's answers to questions pertaining to age, sex, height, weight, health and history of medical treatment of all persons being proposed for coverage on the application. In cases where a past or present medical problem was indicated, the taxpayer could request information from the attending physician and use the plan's written guidelines to make a decision to accept or reject the application. Acceptance could be without qualification or with a temporary or permanent waiver of coverage in one or more areas.

The revenue agent determined that in [redacted] the taxpayer implemented a no-quote list for [redacted] industry groups effective [redacted] for new business. New association business was not being quoted and existing business was closed out or restricted. The rating system was modified to eliminate the possibility of quoting unusually low rates for new under-[redacted] subscriber contract sized groups. Controls were improved in both new and renewal rates by enhancing the level of peer review required for final approval. Percent changes for active groups increased from [redacted]% in [redacted] to [redacted]% in [redacted]. Proposed increases in amounts being charged for coverage increased on renewal policies between [redacted] and [redacted]. The increases to the renewals averaged [redacted]%, [redacted]%, [redacted]% and [redacted]%, respectively.

In response to an IDR, the taxpayer stated that the "no quote" list was temporarily created in the late [redacted]'s as a business response to the underwriting cycle. The taxpayer claims this list was for group sizes between [redacted] and [redacted] and not for small groups, namely, under [redacted] subscribers. The taxpayer alleges the underwriting policies specifically provided that the groups under [redacted] were excluded from the "no quote" list. In [redacted] a new contract for the small group market was introduced. The revenue agent issued an IDR for the old and the new contracts for the small group, but the taxpayer did not provide them.

In a Board meeting held on [redacted] the minutes reflect that the taxpayer's underwriting practices had been too restrictive to the under [redacted] subscriber market, but that its marketing management group had come up with a new strategy to get back into that market.

In [redacted], the state required medical underwriting on groups of less than [redacted] individuals. A group medical questionnaire was required on groups of more than [redacted] employees.

The revenue agent concluded that a material change in operations occurred due to a substantial change in the terms of offering high risk coverage since August 16, 1986.

Prior to that date, the taxpayer underwrote medical insurance for groups of less than [redacted]. In [redacted], the taxpayer changed that practice and began to underwrite groups of less than [redacted]. Newly hired subscribers then had to complete a length of service eligibility period. Furthermore, in [redacted], group contracts specified a [redacted]-month waiting period before coverage of pre-existing conditions took effect. In contrast, during [redacted], all pre-existing conditions were underwritten, except that conversion policies (those leaving an insured group) were issued without evidence of insurability if an application was received during the required time frame. During [redacted], individuals continued to be medically underwritten except that the coverage offered could be waived temporarily or permanently in one or more areas. In addition, expenses incurred during a waiting period in connection with pre-existing conditions were not eligible expenses.

The revenue agent concluded that these changes constituted a material change in operations. The changes were for the purpose of eliminating high risk coverage.

There is some evidence of that contained in the [redacted]'s [redacted] and other documentary evidence secured by the agent.

DISCUSSION

The law related to the taxability of [redacted] organizations was changed by the [redacted] Under prior law, [redacted] organizations were considered to be tax-exempt organizations under I.R.C. § 501(c)(3). The law changed the status of those entities to taxable entities. However, under I.R.C. § 833, special treatment was given to [redacted] organizations providing health insurance if they were in existence on August 16, 1986 and had been tax-exempt for the last taxable year beginning [redacted], provided that no material change occurred in the structure or operations of the organization after [redacted] and before the close of [redacted], or any subsequent taxable year. [redacted] The relevant sections of the legislative history of the statute are discussed below.

A material change in operations occurs if an existing [redacted] organization drops its high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered by the organization from the terms and conditions under which high risk coverage is offered by the

organization from the terms and conditions in effect as of August 16, 1986. A change in high risk coverage is considered substantial if the effect of the change is to defeat the purpose of high risk coverage. High risk coverage for this purpose generally means the coverage of individuals and small groups to the extent the organization (1) provides such coverage under specified terms and conditions as of August 16, 1986, or, (2) meets the statutory minimum definition of high risk coverage for new organizations. A material change in operations does not occur if an existing organization alters its operations to provide high risk coverage that meets the minimum standards under the conference agreement for new [redacted] organizations.

For example, if an existing [redacted] organization provides open enrollment to all individuals and small groups of less than 5 individuals, the organization could redefine a small group for purposes of this coverage to mean the lesser of 15 individuals or the minimum number of individuals required for a small group under State law. Such a redefinition of a small group (from 5 to 15 individuals) would not be considered a material change in operations because the organization would meet the minimum standard for a new organization with respect to small group coverage.

On the other hand, if an existing [redacted] organization provides, as of August 16, 1986, high risk coverage to individuals and small groups without a premium price differential to take account of the high risk nature of the business, a change in premium structure for such individual and small group coverage that has the effect of creating a significant price differential to take account of the high risk nature of the business would be considered a material change in operations.

On or after August 16, 1986, a material change is presumed to occur if an organization ceases to offer coverage for individuals or small groups or conversion coverage for those individuals who leave an employment-based group because the individual terminated employment.

Any change in business practice that either eliminates coverage of high-risk individuals or small groups or that has the effect of eliminating such coverage is a material change in structure or operation. A premium change that reflects normal increases and medical costs is not treated as a material change. A premium increase that has the effect of making high-risk coverage unavailable because of the cost of such coverage is treated as a material change.

A material change in operations occurs if, after August 16, 1986, an organization ceases offering individual or small group coverage in a defined geographic area due to a concentration of high risk individuals in that area. A material change in operations also occurs if subsequent to August 16, 1986, a procedure is implemented to identify particular individuals within the pool of individual enrollment, reassess their individual risk due to excessive utilization, and cancel their coverage.

A material change in operations does not occur if the plan increases its premium rates to reflect increases in health care costs or makes normal changes in products or services to respond to changes and developments generally in the health care environment. The material change in operations rule is not intended to prevent a plan from making normal adjustments in their business practices, such as adjustments to reflect new trends in cost containment or adding new coverage.

The material change in operations rule was not intended to prevent existing [redacted] organizations from changing their high risk coverage to respond better to the needs of the population. For example, a material change would not occur if the organization introduced a preferred provider arrangement or a managed care product for individual high risk coverage that included financial incentives or requirements to use more cost effective providers, such as hospice care rather than hospitalization. The rule also is not intended to prevent existing [redacted] organizations from establishing special coverage that recognizes certain health lifestyles. For example, a material change would not occur if smokers are charged a higher premium than non-smokers.

Based on the information we reviewed, this office believes that the Service needs additional information to support the conclusion that a material change in operations occurred with respect to the operations of [redacted].

First, we suggest that the revenue agent contact the State Insurance Commissioner to obtain all relevant documentary evidence pertaining to [redacted] s rate structures. This includes any application or request to increase rates during the period under examination and the supporting material behind the rate increase request. The Service should also obtain any rulings from the insurance commissioner agreeing to rate increases.

Second, the Service should request information regarding complaints filed with the Insurance Commissioner from groups or

individuals with respect to their coverage being dropped or changed dramatically.

Third, the Service should determine whether the State of [redacted] changed the small group coverage definition between 1986 and 1987.

The Service also should request information regarding certain high risk groups. For example, if evidence is adduced that individuals with acquired immune deficiency syndrome (AIDS) were dropped inappropriately, that may constitute a material change in operations. The same may be true for cancer patients.

It is also important to find out what correlation exists between the [redacted] groups listed in the "no quote" list. The taxpayer claims the "no quote" list did not apply to groups under 14. Are any of the groups listed in the "no quote" list under 15? Are some of them over 15 and some of them under 15? Is there a geographic correlation to those groups? Is there a demographic correlation? Are those listed in the "no quote" list in a particular industry? Are they all in the same industry? What criteria was used to prepare the "no quote" list?

The Service also should secure newspaper articles detailing changes in [redacted] s insurance coverage.

The revenue agent should analyze which policies lapsed. Did the group choose another insurance carrier? Did the premium lapse? Was it due to non-payment? It is also important to compare those policies that lapsed to the rate increases from year to year. Those rate increases then need to be compared between the small groups and the larger groups.

The conclusion that certain small groups or high risk groups were eliminated must be corroborated with statistical information proving that conclusion.

Finally, the revenue agent should secure the balance of the materials requested under the IDR, including the old and the new policies for all groups.

After this information has been secured, we would be glad to meet with the examining agent and render whatever further assistance we can on this issue. If you have any questions, please call me at (404) 331-1292.

Since there is no further legal action to be taken at this time, we are closing our legal file.

[redacted]
Senior Attorney

cc: TL-CATS